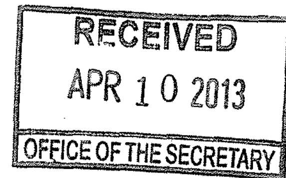

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15141

In the Matter of

MOHAMMED RIAD AND KEVIN TIMOTHY SWANSON

Respondents.

THE DIVISION OF ENFORCEMENT'S PRE-HEARING BRIEF

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I. PRELIMINARY STATEMENT

This matter involves reckless and fraudulent conduct by Respondents Mohammed Riad and Kevin Timothy Swanson, the co-portfolio managers of the Fiduciary/Claymore Dynamic Equity Fund ("HCE" or the "Fund"). HCE was marketed and viewed as essentially a "covered call" fund, a relatively safe and conservative investment vehicle that provided investors additional income over a pure equity investment fund, which offered downside protection in declining markets. However, in mid-2007, Riad and Swanson purposefully and deliberately began making risky derivative investments, including writing naked put options and trading variance swaps, in a quantity and frequency that fundamentally changed the risk profile of the Fund. Although these new investment strategies generated additional income, they also had the potential to cause enormous losses in volatile or declining markets. They were analogous to causing HCE's investors to become insurers of other investors against a large decline in the market.

The new strategies increased HCE's returns for a time. However, as Riad and Swanson must have known, the strategies were inconsistent with HCE's public disclosures and faced the prospect of catastrophic losses. Instead of explaining their derivative investment strategies to HCE's investors in the Fund's 2007 annual and 2008 semi-annual reports, Riad and Swanson falsely attributed the Fund's continued success to their superior stock selection, and they told investors that HCE was appropriately "hedged" for downside protection.

In the volatile and declining markets of September and October of 2008, HCE lost $73 million, which was more than 70% of its Net Asset Value ("NAV"), and $45.4 million of that loss was directly attributable to the Respondents' written put option and variance

swap investments. Riad then attempted to mislead HCE's Board about the reasons for the failure of their investment strategy.

The Division of Enforcement will present evidence showing that Riad and Swanson willfully violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 10b-5, and Section 34(b) of the Investment Company Act of 1940 ("Investment Company Act"), willfully aided and abetted and caused FAMCO's violations of Section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act"), and Advisers Act Rule 206(4)-8, and willfully aided and abetted and caused HCE's violations of Section 34(b) of the Investment Company Act. The Division will also demonstrate that Riad caused HCE's violations of Investment Company Act Rule 8b-16.

II. STATEMENT OF FACTS

A. Background

HCE was a diversified, closed-end investment company with shares offered to the public through a registration statement filed with the Commission on April 26, 2005. (OIP at ¶ 6) HCE was managed by Claymore Advisors, LLC ("Claymore") [1], which acted as the Fund's investment adviser, and Fiduciary Asset Management, LLC ("FAMCO")[2], which

[1] On December 19, 2012, the Commission instituted settled administrative proceedings against Claymore and found that Claymore caused HCE's violations of Investment Company Act Rule 8b-16 and failed reasonably to supervise FAMCO with a view to preventing FAMCO's violations of the federal securities laws. *See* In re Claymore Advisors, LLC, Advisers Act Rel. No. 3519, Investment Company Act Rel. No. 30308 (Dec. 19. 2012).

[2] On December 19, 2012, the Commission instituted settled administrative proceedings against FAMCO and found that FAMCO willfully violated Section 34(b) of the Investment Company Act, Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder by managing HCE in a manner inconsistent with HCE's registration statement and making materially misleading statements and omissions of material fact in HCE's 2007 annual report and 2008 semi-annual report. *See* In re Fiduciary Asset Management,

acted as the Fund's sub-adviser. (OIP at ¶ 6) Claymore's duties were described in an advisory agreement pursuant to which Claymore delegated certain of its duties, including the responsibility for managing HCE's investment portfolio, to FAMCO through a sub-advisory agreement. (OIP at ¶ 8) FAMCO named Riad and Swanson as co-portfolio managers. (OIP at ¶ 9) However, Riad was the senior manager and supervised Swanson. (*Id.*)

HCE's registration statement set out the investment parameters for the Fund, and described its primary investment strategy as investing in equities and writing call options on a substantial portion of those equities. (OIP at ¶ 6) This is commonly called a "covered call" strategy, and trades upside potential in the equities held in the portfolio for income from the option premiums received through the written calls. (*Id.*) In its period reports to investors, HCE further stated that its covered call strategy had the potential to protect the Fund in a downward trending market, and that its goal was to pay investors an annual dividend of 8.5% of the Fund's initial offering price. (OIP at ¶ 7)

FAMCO's sub-advisory agreement with Claymore required FAMCO and the portfolio managers to manage HCE in accordance with the Fund's investment policies. (OIP at ¶ 9) FAMCO, along with Riad and Swanson, also regularly participated in HCE's periodic reporting to investors. (OIP at ¶ 10) For each annual or semi-annual report, Riad provided a signed certification to Claymore stating, to the best of his knowledge, that: (1) he had reviewed the portfolio of investments listed in the report and the list was complete and accurate; and (2) the securities in the portfolio were purchased in compliance with the investment parameters set forth in HCE's prospectus. (OIP at ¶ 10) Each annual and semi-

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LLC, Advisers Act Rel. No. 3520, Investment Company Act Rel. No. 30309 (Dec. 19, 2012).

annual report also contained a Questions and Answers discussion with Riad and Swanson (called a "portfolio manager commentary") that included an introduction specifically attributing the discussion to an interview with Riad and Swanson. (OIP at ¶ 11) The Questions and Answers discussion was put together by a consultant hired by Claymore, based on answers provided by Swanson during recorded interviews. (*Id.*) After the consultant prepared an initial draft of the commentary, Riad, Swanson and others reviewed and edited the Questions and Answers before they were included in a particular annual or semi-annual report. (*Id.*) Swanson also provided Claymore with a signed certification stating that he had reviewed the commentary and, to the best of his knowledge, it did not contain any material misstatement or omissions that would make it inaccurate or misleading. (OIP at ¶ 12)

B. <u>HCE's Put Option and Variance Swap Strategies</u>

Beginning in April 2007 and continuing through October 2008, Riad and Swanson employed two new investment strategies designed to supplement the returns HCE was obtaining from its equity and covered call investments and meet HCE's goal of providing an 8.5% dividend to investors. (OIP at ¶ 13) These strategies consisted primarily of writing short duration, out-of-the-money S&P 500 put options and trading in short variance swaps.[3] (*Id.*) Riad took primary responsibility for managing these strategies, with additional assistance and advice from Swanson. (OIP at ¶ 14) According to Swanson, using these strategies allowed FAMCO to "do more with less" in HCE's portfolio. (*Id.*)

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[3] Variance swaps are essentially a bet on whether actual or realized market volatility will be higher or lower than the market's expectation for volatility (i.e. "implied volatility"). Therefore, a party who is "long variance" makes a profit when realized volatility for the contract period is greater than implied volatility and a party who is "short variance" makes a profit when realized volatility is less than implied volatility. (OIP at ¶ 18)

Riad and a FAMCO research analyst conducted extensive research into these new strategies. However, their research focused on the risks associated with individual written put option or variance swap transactions, rather than the aggregate risks associated with the continued use of these strategies. Riad understood that these strategies could potentially result in severe losses in a volatile or rapidly declining market, but he believed that it was unlikely that HCE's portfolio actually would sustain material losses.

The Division will call Jeffrey Grossman, a former employee of FAMCO with significant options trading experience, to testify that he warned Riad and others at FAMCO about the risk of investor losses associated with the written put option strategy. (OIP at ¶ 22) In response, FAMCO consulted with Claymore and obtained an opinion that HCE was permitted to invest in written put options. However, neither Riad nor Swanson ever described Grossman's concerns about the risk of investor losses to anyone at Claymore.

From April to November 2007, Respondents frequently caused HCE to purchase and write S&P 500 put options in HCE's portfolio nearly simultaneously, with the purchased put options close to at-the-money and the written put options far out-of-the-money. In November 2007, Respondents stopped holding long and written put options together and instead began regularly holding written put options without a corresponding long position in HCE's portfolio. (OIP at ¶ 15) The written put options typically had an expiration of one or two months and strike prices between 6% and 10% below the S&P 500. (OIP at ¶ 16) The "notional exposure"[4] of these options ranged anywhere from 60% to 140% of HCE's NAV, while the premiums generated by the options ranged from approximately $500,000 to $1.4 million in premiums each month, and added approximately

[4] An option's notional exposure is the amount of maximum loss which would be realized on an option if the underlying security or index were to decline to 0. (OIP at ¶ 17 n.2)

0.5% to 1.4% to the Fund's return each time the options expired out-of-the-money. (OIP at ¶ 17) Between April 2007 and August 2008, HCE collected approximately $9.6 million in premiums from its written put options. (*Id.*)

In July 2007, Respondents also began regularly trading short variance swaps for HCE. (OIP at ¶ 19) At nearly all times between July 2007 and October 2008, except for the two-month period between April and June 2008, Respondents maintained both written put options and short variance swaps in HCE's portfolio. (*Id.*) Respondents expected that these derivative investment strategies would add hundreds of basis points to HCE's return each year, provided that there were no significant market disruptions. (OIP at ¶ 20)

However, by using these strategies, Respondents actually increased HCE's exposure to market declines and volatility, and exposed the Fund to massive losses if the S&P were to decline rapidly or become very volatile. (*Id.*) In so doing, Respondents transformed HCE from a fund that provided investors with some downside protection to a fund which magnified downside exposure. (*Id.*)

The Division will call Professor Lawrence Harris as an expert witness who will testify about the manner in which the written put option and variance swap strategy impacted HCE's performance and dramatically changed HCE's risk profile. (*See* Expert Report of Prof. Lawrence Harris at ¶¶ 13 - 40) Specifically, Professor Harris will testify that Respondents' investment strategies increased HCE's return while substantially adding to the riskiness of the Fund's portfolio. (*Id.*) Prof. Harris also will testify that it was the Respondents' derivative investment strategies, rather than market conditions generally, which caused HCE's portfolio to suffer such dramatic losses during the Fall of 2008, and

that adequate backtesting would have shown that Respondents' strategies tended to cause large losses during market disruptions. (*Id.*)

C. Riad's and Swanson's False and Misleading Statements

Neither HCE's registration statement nor its annual reports disclosed the written put options or variance swap trades as principal fund strategies. (OIP at ¶ 44) In addition, neither Riad nor Swanson ever explained the risks associated with the written put option and variance swap strategies to Claymore or HCE's board of directors. (OIP at ¶ 49) To the extent that Riad and Swanson, or anyone at Claymore, viewed HCE's written put and variance swap investments as "Strategic Transactions," the disclosures regarding such investments were general and nonspecific, did not disclose the degree to which such transactions would be used, did not suggest that these derivative investments ever would be principal Fund strategies, and did not disclose the risks associated with these investments. (*See* OIP at ¶¶ 46-47) As a result, HCE's registration statement did not adequately disclose the written put option and variance swap strategies and their inherent risks to investors. (OIP at ¶ 50)

On several occasions between October 2007 and July 2008, Riad described the Respondents' written put option and variance swap strategies in conversations and presentations to Claymore or HCE's Board of Directors as a way to hedge HCE's portfolio against declines in market volatility and "lock in" high market volatility levels. (OIP at ¶¶ 24-26) Riad also described the strategies as a means to mitigate downside risks to HCE's portfolio or to augment downside protection in adverse markets. (*Id.* at ¶ 26) However, none of these statements were true.

HCE had a 12.87% return for the 12-month period from December 1, 2006 through November 30, 2007, with written put options, long put options and written call options contributing approximately 2.0%, 1.7% and 1.7%, respectively to the Fund's return. (OIP at ¶ 29) These investments accounted for 40% of HCE's NAV growth and nearly all of the Fund's excess return above the S&P 500. (*Id.*) Short variance swaps were one of HCE's worst performers during this period, reducing the Fund's return by .4% after only four months of trading. (*Id.*)

However, Riad's and Swanson's commentary in the Questions and Answers section of the 2007 annual report attributed the fund's performance to their stock selection and covered call strategies. (OIP at ¶ 52) In particular, Riad and Swanson highlighted 11 single stock investments that each contributed a smaller return than the Fund's written S&P 500 put and call options. (*Id.*) In discussing which holdings most hurt HCE's performance, Riad and Swanson highlighted four individual stock investments, three of which contributed significantly less to HCE's losses than its variance swap positions. (*Id.*) Moreover, in his interview for the 2007 annual report, Swanson told Claymore's consultant that HCE had appropriately hedged HCE's portfolio to take advantage of spikes in market volatility, when in fact the Fund actually had lost money on the short variance swaps. (OIP at ¶ 57) Moreover, the risk disclosure section of the annual report, which was attributed to the views of the portfolio managers and Claymore, also failed to discuss the risks associated with writing put options and trading variance swaps, including their leveraged exposure to market declines or spikes in market volatility. (OIP at ¶ 58)

HCE obtained at .37% return from December 1, 2007 through May 31, 2008, with written put options, short variance swaps and written call options contributing

approximately 2.1%, .8% and .7%, respectively to the Fund's return. (OIP at ¶ 30) However, the Fund's semi-annual report failed to discuss the written put option and variance swap strategies as having a significant impact on HCE's performance. Instead, Riad and Swanson attributed the fund's performance to stock selection and highlighted the covered call strategy by noting that the call options offset two-thirds of the 3% loss on HCE's equity portfolio. (OIP at ¶ 61) Riad and Swanson further claimed that HCE's portfolio was "strategically hedged for additional downside protection" during most of the period which "proved to be a good decision as equity markets trended downward." (*Id.*) In fact, HCE earned profits on its written put options and short variance swaps during a slight decline in the equity markets, but was exposed to significant losses if the markets had declined more steeply. (OIP at ¶¶ 62-64) Riad and Swanson failed to disclose any of this information in their discussion of the holdings that most helped and hurt HCE's performance. (OIP at ¶¶ 65-66) In addition, in the risk disclosure section of the semi-annual report Riad and Swanson failed to discuss the risks associated with writing put options and trading variance swaps, including their leveraged exposure to market declines or spikes in market volatility. (OIP at ¶ 67)

The Division intends to call certain investor witnesses to testify about disclosure issues, including their view of HCE as a "covered call" fund, and that if they had understood the magnitude of the Fund's investment risks due to the written put option and variance swap strategies, it would have influenced their continuing investment decisions.

D. HCE's Collapse in the Fall of 2008

Respondents continued to write put options and trade variance swaps in HCE's portfolios throughout the summer of 2008. (OIP at ¶ 31) In August of 2008, Riad wrote

two-month, 10% out-of-the-money put options with a notional value of $139 million (nearly 1.4 times HCE's NAV). (*Id.*) FAMCO's internal analysis estimated that these written put options had a potential loss exposure of $17,630,000 (or approximately 17% of the Fund's NAV). (OIP at ¶ 32) Riad also entered into one-month short variance swaps in August 2008. (*Id.*) In August and early September 2008, Riad made similar written put option and variance swap trades in a private hedge fund he managed for himself and several principals of FAMCO. (OIP at ¶ 33)

In early September 2008, the financial markets became quite volatile and began declining rapidly. (OIP at ¶ 34) Around this time, Fannie Mae and Freddie Mac were placed into conservatorship and Lehman Brothers filed for bankruptcy. On September 10, 2008, Riad drafted an internal email stating that: "Sean [Hughes] told me this would happen. Never sell variance in front of a broker/dealer disaster." (*Id.*) On September 16, 2008, the day after Lehman Brothers filed for bankruptcy, Riad closed out the written put position in the private hedge fund owned by the FAMCO principals -- but he kept HCE's written put position open. (*Id.*)

On September 19, 2008, Riad settled HCE's expiring one-month variance swap position at a loss of approximately $7 million. (OIP at ¶ 36) At that time, HCE had a $1.25 million liability on the written put options and FAMCO's internal estimate of its potential exposure on written put options had grown to $39.7 million (or approximately 44% of the HCE's NAV). (*Id.*) The next day, Riad entered into two new one-month short variance swaps for HCE's portfolio. (*Id.*)

The financial market continued to decline with increased volatility in late September and early October 2008. (OIP at ¶ 37) HCE covered its written put positions in

early October at a $15.5 million loss. HCE also lost an additional $22.8 million on the new variance swap contracts. As a result, HCE lost approximately $73.4 million (or 72.8% of its NAV) during September and October 2008. (OIP at ¶ 38) These losses far exceeded the declines in the S&P 500 or the CBOE's Buywrite Monthly Index ("BXM") which simulated an S&P 500 covered call strategy. Of HCE's total losses in September and October 2008, approximately $45.4 million were directly attributable to the Fund's written put option and variance swap strategies. (OIP at ¶ 38)

III. LEGAL ANALYSIS

The Division will show, by the preponderance of the evidence, that Riad and Swanson acted knowingly, recklessly and negligently in making misleading statements and omitting to state material facts in HCE's 2007 annual and 2008 semi-annual reports. *See* Steadman v. SEC, 450 U.S 91, 102-03 (1980); In the Matter of Sandra K. Simpson and Daphne Ann Pattee, Exchange Act Rel. No. 45923, 77 SEC Docket 1784, 2002 WL 987555 at *16 (May 14, 2002).

A. Riad and Swanson Willfully Violated the Antifraud Provisions of the Exchange Act and the Investment Company Act

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit any person, in connection with the purchase or sale of any security, from directly or indirectly: (a) employing any device, scheme, or artifice to defraud; (b) making any untrue statement of a material fact or omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) engaging in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. Section 34(b) of the Investment Company Act prohibits any person from making any untrue statement of a material fact in any registration

statement or other document filed or transmitted under the Investment Company Act. It also prohibits any person filing, transmitting or keeping any such document from omitting to state any fact necessary in order to prevent the statements made, in the light of the circumstances under which they were made, from being materially misleading.

A misstatement or omission is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988). *Scienter*, defined as a "mental state embracing the intent to deceive, manipulate or defraud," is a required element of a Section 10(b) claim. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). Reckless conduct also satisfies the *scienter* requirement. *See* SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1044 (7th Cir. 1977); *cert denied*, 434 U.S. 875 (1977). Proof of *scienter* need not be direct, but may be a matter of inference from circumstantial evidence. *See* Herman & Maclean v. Huddleston, 459 U.S. 375, 390 n.30 (1983). Section 34(b) of the Investment Company Act does not require a showing of *scienter*. In re Fundamental Portfolio Advisors, Inc., Investment Company Act Rel. No. 26099, 56 S.E.C. 651, 670 (July 15, 2003).

The Division will show that Riad and Swanson made false and misleading statements in the Questions and Answers discussion in HCE's 2007 annual report and 2008 semi-annual report. Specifically, Riad and Swanson claimed that the most significant contributors to HCE's performance, both positive and negative, were individual stock selections and the Fund's covered call strategy, and failed to mention the more substantial effect that their derivative investment strategies had on HCE's return. Even worse, in discussing what they described as "hedging" strategies, Riad and Swanson also failed to

inform investors that the written put option and variance swap strategies exposed the Fund to significant downside risk and investment losses during periods of market decline or volatility. Riad and Swanson never described their written put option and variance swap investment as principal investment strategies, which they clearly were both in terms of risk and return.

This information was material to investors. By distorting the actual drivers of HCE's performance, and the Fund's exposure to (and lack of protection from) downside risk, Riad and Swanson concealed from investors the fact that HCE was achieving its favorable returns in large part by making aggressive investments with significant additional downside risk. The fact that the magnitude of this risk was material can be demonstrated by HCE's significant losses above and beyond those achieved by the market as a whole in the fall of 2008, and the fact that investors were unaware that they were exposed to losses of such a magnitude. Reasonable investors would have considered information about HCE's risk profile as important, because the Fund's performance differed from other covered call funds, which would be expected to outperform a pure equity strategy during market declines.

The Division's evidence will be sufficient to show that Riad and Swanson acted knowingly, recklessly and negligently. FAMCO created portfolio attribution charts which showed Respondents how the Fund's derivative strategies contributed to HCE's return, yet they failed to mention the performance of their derivative strategies in response to specific questions about the various contributors to the Fund's performance. They also misleadingly stated that the Fund was hedged for downside protection when they knew or were reckless in not knowing that their written put options and short variance swaps had

exposed HCE to additional downside risks and potential losses. Riad further compounded the problems caused by Respondents' misleading statements by making false and misleading statements about Respondents' investment strategies to Claymore and HCE's board members.

Riad and Swanson each qualify as "makers" of the false and misleading statements and omissions within the meaning of Janus Capital Group, Inc. v. First Derivative Traders, 131 S.Ct 2296, 2302 (2011) (a "maker" is a person or entity "with ultimate authority over the statement, including its content and whether and how to communicate it . . . attribution within a statement or implicit from surrounding circumstances is strong evidence that a statements was made by – and only by – the party to whom it is attributed."). The introductions to the Questions and Answers discussions and the Risks sections of the 2007 annual report and the 2008 semi-annual report directly attribute the statements made in those sections to Riad and Swanson as HCE's portfolio managers.

B. Riad and Swanson also Aided and Abetted and Caused HCE's Violations of Section 34(b) of the Investment Company Act

In addition to their direct violations of Section 34(b), Riad and Swanson aided and abetted and caused HCE's violations of the law. To establish aiding and abetting liability under the federal securities laws, the Division must show: (1) a primary violation; (2) awareness or knowledge by the aider and abettor that his or her role was part of an overall activity that was improper; and (3) that the aider and abettor knowingly and substantially assisted the conduct constituting the violation. *See* Graham v. SEC, 222 F.3d 994, 1000 (D.C. Cir. 2000). A showing of recklessness is sufficient to establish the knowledge or awareness requirement. *See* In re vFinance Invs., Inc., Exchange Act Rel. No. 62448 (July 2, 2010), 98 SEC Docket 2879, *citing* Graham v. SEC, 222 F.3d 994, 1004-06 (C.A.D.C.

2000); Monetta Fin. Servs., Inc. v. SEC, 390 F.3d 952, 956 (7th Cir. 2004); *see also* Howard v. SEC, 376 F.3d 1136, 1143 (D.C. Cir. 2004) ("A secondary violator may act recklessly, and thus aid and abet an offense, even if he is unaware that he is assisting illegal conduct.").

To establish causing liability, the Division must show: (1) a primary violation; (2) an act or omission by the respondent that was a cause of the violation; and (3) that the respondent knew, or should have known, that his conduct would contribute to the violation. In re Robert M. Fuller, 56 S.E.C. 976, 984 (2003), pet. denied, No. 03-1334 (D.C. Cir. 2004). A respondent who aids and abets a violation also is a cause of the violation. *See* In re Sharon M. Graham, 53 S.E.C. 1072, 1085 n.35 (1998), aff'd 222 F.3d 994 (D.C. Cir. 2000). Negligence is sufficient to establish liability for causing a primary violation that does not require *scienter*. *See* KPMG Peat Marwick LLP, 54 S.E.C. 1135, 1175 (2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002).

By making misleading statements and omissions in its 2007 annual and 2008 semi-annual reports, HCE violated Section 34(b) of the Investment Company Act. Riad and Swanson aided and abetted and caused HCE's violations by making misleading statements and omitting material information in the Question and Answers discussions and Risks disclosures sections of HCE's 2007 annual report and 2008 semi-annual report. As discussed above, the Division can show that Riad and Swanson acted recklessly and negligently in making these misstatements.

C. **<u>Riad and Swanson Aided and Abetted and Caused FAMCO's Violations of Section 206(4) of the Advisers Act and Rule 206(4)-8 Thereunder</u>**

Section 206(4) of the Advisers Act prohibits an investment adviser from engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. Rule 206(4)-8 states that it shall constitute a fraudulent, deceptive, or manipulative act, practice or course of business for an investment adviser of an investment company to: (1) make any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor in the investment company; or (2) otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any of the investment company's investors or prospective investors. Section 206(4) does not require a showing of *scienter*. <u>SEC v. Steadman</u>, 967 F.2d 636, 647 (D.C. Cir. 1992).

By utilizing undisclosed investment strategies to such a degree that those strategies became an integral part of HCE efforts to achieve favorable investment returns, and by exposing the Fund to additional undisclosed risks, Riad managed HCE in a manner that operated as a fraud on its investors and conflicted with the Questions and Answers discussion in HCE's 2007 annual and 2008 semi-annual reports. As a result, Riad aided and abetted and caused FAMCO's violations of Section 206(4) and Rule 206(4)-8(a)(1).

Similarly, by making false and misleading statements to investors in HCE's 2007 annual and 2008 semi-annual reports, Riad and Swanson aided and abetted and caused FAMCO's violations of Section 206(4) and Rule 206(4)-8(a)(1).

D. Riad Caused HCE's Violations of Rule 8b-16 Under the Investment Company Act

Rule 8b-16 under the Investment Company Act requires investment companies to amend their registration statements annually. Rule 8b-16-(b) exempts closed-end funds from the annual amendments if they include, among other things, in annual reports to shareholders: (1) any material changes in the company's investment objectives or policies that have not been approved by shareholders; and (2) any material changes in the principal risk factors associated with investment in the company.

HCE violated Rule 8b-16 by failing to amend its registration statement or disclose in its 2007 annual report the material changes to the Fund's investment policies and principal risk factors due to Respondents' written put option and variance swap strategies.

Riad was primarily responsible for managing the written put option and variance strategies for HCE. Even though he was aware that HCE's registration statement did not disclose the written put option and variance swap strategies as principal fund strategies or primary drivers of performance and also failed to disclose the risks associated with writing puts or trading variance swaps, Riad continued to use these derivative investment strategies to such a degree that they became an integral part of the manner in which HCE sought to achieve its investment objectives in 2007 and 2008. Riad also failed to raise the disclosure issue with Claymore, and contributed to HCE's disclosure failures by describing the strategies as augmenting downside protection in discussions with Claymore and HCE's board of directors. By doing so, Riad acted recklessly or at least negligently in causing HCE's violations of Rule 8b-16.

E. Riad and Swanson Have Offered No Viable Defenses

In their Answers, neither Riad nor Swanson has offered any explanation that would constitute a legally sufficient defense to the charges at issue in this matter.

The Division anticipates that the Respondents may claim, as they did during the Division's investigation, that the written put option and variance swap strategies were fully disclosed in HCE's registration statement, that HCE's periodic reports accurately portrayed the Fund's performance, and that they each acted with due care and in good faith. The Division also anticipates that the Respondents also may assert that the Division's case for direct liability is barred by Janus Capital Group, Inc. v. First Derivative Traders, 131 S.Ct 2296, 2302 (2011). Finally the Division expects that Respondents will argue that this matter should be dismissed based on the time requirements of Section 929U of the Dodd-Frank Act, as codified in Section 4E of the Exchange Act. None of these arguments is valid.

1. *HCE's Registration Statement Disclosures*

Riad and Swanson may argue that HCE's registration statement authorized their use of written put options and variance swaps in HCE's portfolio. Although written put options and variance swaps were not described in the registration statement's description of the types of investments HCE would make under normal market conditions, the registration statement stated that the Fund may engage in certain "Strategic Transactions." Neither the registration statement nor the Statement of Additional Information revealed that any "strategic transactions" would be used as regular fund strategies (and in fact they implied the opposite). Because Riad and Swanson held written put options or short variance swaps in HCE's portfolio more than 80% of the time

from April 2007 through mid-October 2008, these investments became an integral part of Respondents' efforts to achieve HCE's dividend payments and investment objectives. Moreover, the registration statement's disclosures of risk failed to address the principal risks from the Respondents' derivative investment strategies or disclose HCE's exposure to significant losses during declining markets or periods of increased volatility which accompanied the written put option and variance swap investments.

These deficiencies in HCE's registration statement were not cured by disclosures in any of HCE's periodic reports, including the 2007 annual report or the 2008 semi-annual report. These reports only provided snapshots of fund holdings on a specific date, and did not provide any narrative description of Riad and Swanson's derivative investment strategies for the Fund. Moreover, investors could not glean from the periodic reports whether the transactions were isolated transactions or part of a consistent investment strategy. In addition, as discussed below, the periodic reports' risk disclosure sections did not discuss any of the specific risks associated with the written put option and variance swap strategies.

2. *HCE's Periodic Report Disclosures*

Respondents also contend that the Questions and Answers discussions in the 2007 annual report and 2008 semi-annual report did not contain any misstatements or omissions. For the 2007 annual report, the Division anticipates that Riad and Swanson will argue that written put options were a minor contributor to performance compared to the equity and covered call strategies, that the written put options were disclosed through their reference to the use of "collars," and that variance swaps were not a material contributor to HCE's performance. For the 2008 semi-annual report, Riad and Swanson

likely will argue that they identified written put options as a contributor to performance, that variance swaps were not a material contributor to performance, and that HCE in fact had been hedged for additional downside protection.

However, it is misleading to view the written put options as only a minor contributor to HCE's performance in 2007 – when compared to HCE's equity portfolio and covered call strategy. Riad and Swanson's stock selection paled in comparison to the overall contribution of the written put options. Taken as a whole, HCE's equity portfolio returned 7.97% net of fees, barely beating the S&P 500's return of 7.72% during the same time. In contrast, HCE's derivative strategies, including the written put options, were almost exclusively responsible for the fact that HCE outperformed the S&P 500 by 5%. And these gains came at the expense increased downside risk to the Fund's portfolio. Short variance swaps, on the other hand, generated a .4% loss, which was significantly more than three of the four individual investments listed by Riad and Swanson in the annual report as the largest loss contributors.

Despite the fact that written put options were the single largest positive contributor to HCE's performance in the first half of 2008, Riad and Swanson did not even mention written put options in the 2008 semi-annual report as a significant contributor to performance. Moreover, Riad and Swanson stated that the portfolio was hedged for downside protection even though the written put options and variance swaps actually exposed the portfolio to downside risk, and failed to protect the portfolio against market declines.

3. *Scienter*

Riad and Swanson assert in their Answers that they acted in good faith and with due care in employing the derivative strategies and that there is no evidence they acted with *scienter*.[5] As explained above, the Division will be able to demonstrate that both Riad and Swanson misled and withheld information from Claymore, HCE's Board, and investors about the risks associated with the put-writing and variance swap strategies. Further, on several occasions Riad told Claymore and HCE's board that the purpose behind the strategies was to ensure that HCE's portfolio was properly hedged against declines in market volatility and to mitigate any downside risks to the portfolio. Contemporaneous messages will show that both Riad and Swanson knew this was not true. In addition, the Division's expert witness Prof. Lawrence Harris will testify that Riad and Swanson's strategies did exactly the opposite of what they said – further exposing the Fund to market declines and volatility as they aggressively chased positive return.

Riad and Swanson cannot claim that they were unaware that the written put option and variance swap strategies had a significant impact on HCE's return. To the contrary they regularly received portfolio attribution reports showing exactly how the various investments in HCE's portfolio, including the written put options and variance

[5] The fact that Claymore and its legal counsel authorized Respondents to engage in written put options and variance swaps is insufficient to prove that Riad or Swanson acted in good faith. First, neither Claymore nor its counsel were consulted until some months after Respondents began making written put and variance swap investments. Second, FAMCO consulted Claymore and its legal counsel because Jeffrey Grossman advised a FAMCO compliance manager that the written put options were dangerously risky – and Respondents never shared that particular concern with Claymore or its counsel. And third, Respondents never sought Claymore's or HCE's permission to make written put option or variance swap investments of a size or magnitude which approached the Fund's NAV.

swaps, had performed. Yet, instead of telling investors of the significant impact the put-writing and variance swap strategies had on HCE's portfolio, Respondents crafted a narrative which touted their expertise at picking stocks and making equity investments on behalf of HCE.

In the 2007 annual report, Riad and Swanson claimed that they had appropriately hedged HCE's portfolio to take advantage of spikes in market volatility, when in fact they actually had lost money on HCE's short variance swaps. In the 2008 semi-annual report, Riad and Swanson claimed the portfolio was strategically hedged for downside protection, even though their continued use of written put options and variance swaps exposed HCE to even greater losses in periods of significant market decline or volatility. Under these circumstances, Respondents' s*cienter* can be inferred from an awareness of information which contradicted their public statements. *See* Fla. State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 665 (8th Cir. 2001) ("One of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate.")

4. *Janus Capital Group, Inc. v. First Derivative Traders*

The Respondents' assertion that the Division's allegations are barred by the Supreme Court's ruling in Janus is contrary to Supreme Court precedent and the recent lower court decisions addressing this issue. The Supreme Court has stated that "attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by – and only by – the party to whom it is attributed." Janus, 131 S.Ct. at 2302, 05. The Questions and Answers sections of HCE's

annual and semi-annual reports clearly and expressly attribute all of the statements in the discussions to interviews with Riad and Swanson. In fact, the answers came directly from recorded interviews of Swanson and were subject to Riad's and Swanson's review and approval. Swanson also signed certifications that the Questions and Answers discussions did not contain any misstatements and were not misleading.

Accordingly, Riad and Swanson may be considered the "makers" of these statements within the meaning of Janus. They cannot avoid liability for statements directly attributed to them simply because those statements were part of a report that was not theirs in its entirety. *See, e.g.*, Lopes v. Viera, 2012 WL 6916665, at *6 (E.D. Cal. Mar. 2, 2012) (defendant can be held primarily liable for information contained in company's offering memorandum specifically attributed to defendant, even though the document as a whole was not defendant's). Riad and Swanson similarly may be held liable as the "makers" of their statements under Section 34(b). *See, e.g.*, SEC v. Daifotis, 2011 WL 3295139, at *6 (N.D. Cal. June 12, 2012); and 874 F.Supp.2d 870, 878 (N.D. Cal. 2012) (defendant can be held liable for Section 34(b) violation as the maker of statements even if defendant was not responsible for filing, transmitting, or keeping the document).

5. *Dodd-Frank Section 929U*

The Respondents' contention that this action was not timely filed within the deadline set forth in Section 929U of the Dodd-Frank Act (codified as Section 4E(a) of the Exchange Act) is meritless. Nothing in the Dodd-Frank Act requires the Division to provide evidence of compliance with Section 929U, so the Respondents have no grounds for challenging the Division's conformity with the statute. Further, Section 929U is not a

statute of limitations and does not divest the Commission of jurisdiction to act. Instead, it merely provides an internal deadline for the benefit of the Commission's staff. *See* SEC v. Levin, 2013 WL 594736 at *13 (S.D. Fla. Feb. 14, 2013); SEC v. The NIR Group, LLC, 2013 U.S. Dist. LEXIS 47522 at **10-12 (E.D.N.Y. March 24, 2013).

Moreover, the Division has fully complied with the requirements of Section 929U in connection with the filing this action.[6] As discussed in the Declaration of Anne C. McKinley attached hereto as Exhibit 1, the Division sought and received from the Director of Enforcement several extensions totaling 83 days from the initial 180-day deadlines under Section 929U. (*See* McKinley Decl. at ¶¶ 4, 5, 7, 8, 9, 10) The Division Director authorized each of these extensions based upon a determination that the investigation was "sufficiently complex" to justify the extension. (*Id.* at ¶¶ 5, 8, 10) The Division Director also provided notice of each such extension to the Chairman of the Commission. (*Id.*)

Administrative Law Judges have declined to grant motions to dismiss, and the Commission has declined petitions for interlocutory review, based on Section 929U challenges under similar circumstances in several other actions. *See, e.g.*, In re Gualario & Co., LLC and Ronald Gualario, AP Rulings Rel. No. 680 (Aug. 11, 2011); In re Montford and Co., Inc. d/b/a Montford Assoc., and Ernest V. Montford, Sr., AP Rulings Rel. No. 684 (Oct. 18, 2011) *petition for rev. denied*, Advisers Act Rel. No. 3311 (Nov. 9, 2011) *motion for reconsideration denied*, Rel. No. 457 (April 20, 2012), 2012 WL

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[6] The request for and granting of a Section 929U extension is part of the deliberative process of the staff and the Commission, and is at the heart of that privilege, along with the attorney-client privilege, the attorney work-product privilege and the law enforcement privilege. To the extent the Court deems any additional evidence of our compliance with Section 929U relevant, the Division requests that such information be provided to the Court for *in camera* review.

1377372, at *11; In re Eric David Wanger and Wanger Investment Management, Inc., AP Rulings Rel. No. 692 (Feb. 21, 2012) *petition for rev. denied*, Exchange Act Rel. No. 66678 (March 29, 2012); In re optionsXpress, Inc., Thomas E. Stern and Jonathan I. Feldman, AP Rulings Rel. No. 721 (Aug. 27, 2012); In re Michael Bresner, Ralph Calabro, Jason Konner and Dimitrios Koutsoubos, AP Rulings Rel. No. 729 (Oct. 17, 2012).

IV. SANCTIONS

The public interest would be served by sanctioning Riad and Swanson. In determining whether sanctions should be imposed in the public interest, courts and the Commission may consider the following elements: the egregiousness of the actions; the isolated or recurrent nature of the infractions; the degree of scienter involved; the sincerity of a respondent's assurances against future violations; a respondent's recognition of the wrongful nature of his or her conduct; and the likelihood that a respondent's occupation will present opportunities for future violations. *See* Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981) (*quoting* SEC v. Blatt, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)).

In addition to these factors, the Commission also may consider the age of the violations and the degree of harm to investors and the marketplace as a result of the violations. *See* In the Matter of Marshall E. Melton, et al., Advisers Act Rel. No. 2151 (July 25, 2003), 2003 WL 21729839, at *2. The Commission also may consider the extent to which a sanction will have a deterrent effect. *See* In the Matter of Schield Management Co., et al., Exchange Act Rel. No. 53201 (Jan. 31, 2006), 2006 WL 23162, at *8.

Riad's and Swanson's misconduct was egregious and recurred throughout 2007 and 2008. They have offered no assurances against future violations or acknowledged the wrongful nature of their conduct. Although neither Riad nor Swanson has any prior disciplinary history, both are relatively young and continue to seek employment in the securities industry. Both would have ample opportunities to commit future violations. In addition, investors lost approximately $45.4 million as a result of Respondents' conduct.

A. Cease and Desist Orders are Appropriate

Section 21C of the Exchange Act, Section 203(k) of the Advisers Act and Section 9(f) of the Investment Company Act authorize the Court to issue cease-and-desist orders. Riad's and Swanson's violations raise a sufficient risk of future violations to support the entry of such an order. *See* In the Matter of KPMG Peat Marwick LLP, Exchange Act Rel. No. 43862 (Jan. 19, 2001), 54 S.E.C. 1135, 1183-91 (the showing for a cease-and-desist order is "significantly less than that required for an injunction," and "absent evidence to the contrary," a single past violation may raise "a sufficient risk of future violation").

B. Disgorgement and Prejudgment Interest Are Appropriate

Section 21C(e) of the Exchange Act, Section 203(k)(5) of the Advisers Act and Section 9(f)(5) of the Investment Company Act authorize the Court to require disgorgement, plus reasonable interest. During 2008, both Riad and Swanson profited from their violations by receiving a base salary and a substantial bonus. During 2007, Swanson received an even greater amount in salary and bonus, and Riad received a salary plus more than $ 1 million in profit sharing payments from FAMCO. In the event Respondents are found liable, these amounts may serve as the basis for calculating a disgorgement award.

To determine the appropriate amount of disgorgement, the Division only needs to show that the amount of disgorgement is a reasonable approximation of the profits from the violative conduct. *See* SEC v. First City Fin. Corp., 890 F.2d 1215, 1231 (D.C. Cir. 1989). The burden then shifts to the respondent to show that the approximation is inaccurate. *Id.* Accordingly, the Division respectfully requests that the Court order Riad and Swanson to disgorge that portion of their 2007 and 2008 earnings which approximates the profits they earned from their violations of the securities laws, plus prejudgment interest.

C. Civil Penalties are Appropriate

The public interest would be served by requiring Riad and Swanson to pay significant civil penalties for their misconduct. *See* Section 21B of the Exchange Act, Section 203(i) of the Advisers Act, and Section 9(d) of the Investment Company Act. In considering whether civil penalties are in the public interest, the factors to consider include: (1) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm to other persons resulting either directly or indirectly from such act or omission; (3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior; (4) whether such person previously has been found by the Commission, another appropriate regulatory agency, or a self-regulatory organization to have violated the federal securities laws, state securities laws or self-regulatory rules, has been enjoined from violating such laws or rules, or has been convicted of violations of such laws or of any felony or misdemeanor described in Section 15(b)(4)(B) of the Exchange Act or Section 203(e)(2) of the Advisers Act; (5) the need to deter such person and other

persons from committing such acts or omissions; and (6) such other matters as justice may require. *Id.*

The evidence will show that either second-tier penalties of up to $65,000 or third-tier civil penalties of up to $130,000 for each violation are appropriate against Riad and Swanson. *See* 17 C.F.R. § 201.1003. Based on the multiple violations, the use of fraud, deceit, manipulation or a deliberate or reckless disregard of regulatory requirements, the substantial harm and risk of harm to investors and the need to deter Riad and Swanson from committing future violations, the Division respectfully requests that the Court impose third-tier penalties against each of the Respondents. *See, e.g.*, In re Fundamental Portfolio Advisors, Inc., Lance M. Brofman, and Fundamental Serv. Corp., Securities Act Rel. No. 8251 (July 15, 2003), 80 SEC Docket 2234 (cease and desist order, civil penalty of $250,000 and permanent associational bar ordered against portfolio manager who misled investors about a new risky investment strategy in the mutual fund he managed); SEC v. Kimon P. Daifotis and Randall Merk, Lit. Rel. 22415 (July 16, 2012) (settlement imposing disgorgement of $250,000 and civil penalty of $75,000 against portfolio manager enjoined for misleading investors about the risks of investing in a bond fund). The amount of any civil penalty assessed against both Riad and Swanson should be sufficient to deter them and others from engaging in the type of conduct at issue in this proceeding.

D. Permanent or Temporary Associational Bars are Appropriate

Under Section 203(f) of the Advisers Act, Section 9(b) of the Investment Company Act and Section 15(b)(6)(A) of the Exchange Act, as amended by Section 925 of the Dodd-Frank Act, the Commission may bar or suspend registered persons from being associated with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor,

transfer agent, or nationally recognized statistical rating organization. *See* In the Matter of John W. Lawton, Advisers Act Rel. No. 3513 (December 13, 2012), 2012 WL 6208750 (collateral bars imposed pursuant to Section 925 of Dodd-Frank are not impermissibly retroactive as applied in proceedings based on pre-Dodd-Frank conduct).

Based on Riad's and Swanson's willful violations and orders entered in similar proceedings, it is appropriate to impose an associational bar on both Riad and Swanson which would preclude their continued employment in the securities industry. *See, e.g.*, In re Top Fund Management, Inc. and Barry C. Ziskin, Securities Act Rel. No. 9377 (Dec. 21, 2012) (settlement imposing collateral bar against mutual fund manager from the securities industry for failing to follow the investment objectives of a stock mutual fund, leading to the fund's collapse); SEC v. Kimon P. Daifotis and Randall Merk, Lit. Rel. 22415 (July 16, 2012), Exchange Act Rel. No. 67454, 2012 WL 2921019 (July 18, 2012) (settlement imposing collateral bar with right to reapply after three years against portfolio manager enjoined for misleading investors about the risks of investing in a bond fund); In re Fundamental Portfolio Advisors, Inc., Lance M. Brofman, and Fundamental Serv. Corp., Securities Act Rel. No. 8251 (July 15, 2003), 80 SEC Docket 1851 (permanent associational bar ordered against portfolio manager who misled investors about a risky investment strategy). The length of Respondents' associational bar should be sufficient to protect investors from the type of harm which is at issue in this proceeding.

V. CONCLUSION

The Division of Enforcement respectfully requests that the Court accept the documentary and testimonial evidence presented at the hearing, find that Respondents Riad

and Swanson engaged in the violations described in the Order Instituting Proceedings, and impose appropriate sanctions.

Dated: April 8, 2013.

Respectfully submitted,

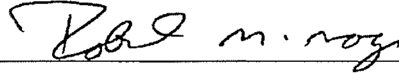

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EXHIBIT 1

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15141

In the Matter of

MOHAMMED RIAD
AND KEVIN TIMOTHY
SWANSON,

Respondents.

DECLARATION OF ANNE C. MCKINLEY

1. My name is Anne C. McKinley. I am an Assistant Regional Director in the Division of Enforcement ("Division") of the Securities and Exchange Commission ("Commission") in the Structured and New Products Specialty Unit and the Chicago Regional Office. The facts stated in this declaration are based upon my personal knowledge, my review of internal records and my communications with Commission staff.

2. On April 3, 2012, the Division issued a written Wells notice to Respondent Mohammed Riad in the investigation titled In the Matter of Fiduciary-Claymore Dynamic Equity Fund, Investigation No. C-07662, making the initial 180-day period under Section 929U of the Dodd-Frank Act (codified as Section 4E(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78d-5(a)) end on September 30, 2012.

3. On April 19, 2012, the Division issued a written Wells notice to Respondent Kevin Timothy Swanson, making the initial 180-day period under Section 929U of the Dodd-Frank Act end on October 16, 2012.

4. On September 10, 2012, the Division submitted a request to the Division Director pursuant to Section 929U of the Dodd-Frank Act, seeking to extend the initial 180-day deadline to institute enforcement proceedings against Respondents Riad and Swanson and others. The request sought a 34-day extension until November 2, 2012.

5. On September 12, 2012, after having determined pursuant to Section 929U(a)(2) that the matter was sufficiently complex such that a determination regarding the filing of an action could not be completed by September 30, 2012, and after providing notice to the Chairman of the Commission, the Division Director granted the requested extension.

6. Section 929U(a)(2) gives the Division Director the discretion to provide an extension of up to 180 additional days beyond the initial 180-day period, which in this case would be until March 29, 2013 for Riad and April 14, 2013 for Swanson.

7. On October 22, 2012, the Division submitted a second request pursuant to Section 929U of the Dodd-Frank Act, seeking to extend the 180-day deadline to institute enforcement proceedings against Respondents Riad and Swanson and others 17 additional days until November 19, 2012.

8. On October 31, 2012, after having determined that the matter was sufficiently complex within the meaning of Section 929U(a)(2), the Division Director provided notice of the request to the Chairman of the Commission and approved the request.

9. On November 13, 2012, the Division submitted a third request pursuant to Section 929U of the Dodd-Frank Act, seeking to extend the 180-day deadline to institute enforcement proceedings against Respondents Riad and Swanson and others 32 additional days until December 21, 2012.

10. On November 14, 2012, after having determined that the matter was sufficiently complex within the meaning of Section 929U(a)(2), the Division Director provided notice of the request to the Chairman of the Commission and approved the request.

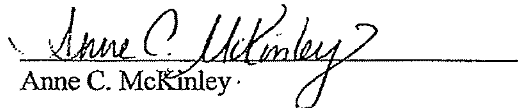
11. On November 20, 2012, the Commission authorized the institution of litigated administrative proceedings against Riad and Swanson.

12. On November 20, 2012, the Division informed Riad's and Swansons' counsel that the staff had obtained Commission authorization to institute the litigated administrative proceedings against them.

13. On December 19, 2012, the Commission instituted litigated administrative proceedings against Riad and Swanson.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on 8 April 2013



Anne C. McKinley